

June 2, 2006

Mr. Richard Krolak
Chief, CalPERS Office of Long Term Care
400 P Street, 5th floor
Sacramento, CA 95814

Subject: CalPERS LTC Program – Proposed Mitigation Initiatives
and Supporting Data/Information

Dear Mr. Krolak:

The purpose of this document is to present a number of proposed mitigation initiatives for review and discussion along with relevant data/information to support the development of a comprehensive mitigation plan.

Background

The first recommendation presented in the 2005 valuation report reads as follows:

“Implement one or more initiatives effective as soon as possible that, in the aggregate, would impact projected future results in a manner consistent with the impact of a 20% rate increase.”

In subsequent letters dated January 4th, February 14th, February 27th, March 29th and April 28th, the following mitigation-related items have been discussed:

- Various proposed mitigation initiatives and associated projected financial impact estimates.
- Various average rate increase scenarios, both with and without provision for shock lapsation and resulting antiselection.
- A sample proposed comprehensive mitigation plan.
- The cost of delaying the implementation of a mitigation plan.
- Rates for the 2006 enrollment period.

As indicated above, the purpose of this document is to present a number of proposed mitigation initiatives for review and discussion along with relevant data/information to support the development of a comprehensive mitigation plan. The intent here was not to develop new data/information, but to incorporate relevant work performed to date into a single presentation that would facilitate the development of a comprehensive mitigation plan.

The items listed below are presented in the following sections:

- Projection results – a revised starting point.
- Target(s) to consider.
- Rate increase scenarios.
- New business scenarios.
- Plan migration scenarios.
- Improved claims management processes and procedures.
- An initial proposed comprehensive mitigation plan.
- A note regarding implementation.
- Benchmarking, measurement and reporting.

Projection Results – A Revised Starting Point

Attachment A summarizes what we have been treating as the “base case” projection scenario from the 2005 valuation for the purpose of quantifying the deficit/surplus for this program. It indicates that there was a projected deficit as of 6/30/05 of approximately 39% of the present value of future premiums.

Since finalizing the 2005 valuation, we have discovered a few adjustments that could have been made to the assumed morbidity. While each of these adjustments is relatively small, their combined impact is not insignificant, and especially so given the leveraged impact of any assumption changes on projection results (e.g., a revision to the assumed morbidity of 1% impacts the projected deficit/surplus by 2%).

We expected to reflect these adjustments in quarterly projection updates as we identified them; however, given everything else we have been working on over the last six months, the 2005 projections have not been updated as originally intended. Our expectation is that regular quarterly projection updates will resume after work on the mitigation plan and the 2006 valuation have been completed.

Please note that these revisions are not based on a review of more current morbidity data, but on slightly revised interpretations and conclusions drawn from the data and analyses used to develop the assumptions used in the 2005 valuation.

Attachment B summarizes the “base case” projection revised to reflect the revisions to assumed morbidity described above. It indicates that there was a projected deficit as of 6/30/05 of approximately 28% of the present value of future premiums. All results presented below will be based on the projection results from this scenario.

Target(s) to Consider

While it would take a mitigation impact of approximately 28% as of 6/30/05 to eliminate the projected deficit as of 6/30/05, that should not be our target. Per previous discussions with and decisions made by both the LTC Advisory Committee and the CalPERS Board,

we should be targeting an explicit margin of at least 10% at a 7.79% discount rate. Building in this margin increases the projected funding deficit from approximately 28% to approximately 43% of the present value of future premiums.

Given the introduction of explicit margin into this process, the work recently performed regarding 2006 rates, and based on discussions with CalPERS staff, we decided to re-run the revised “base case” scenario assuming that 2006 rates were in effect beginning 7/1/05. Attachment C summarizes the results of this revised projection. To give you a frame of reference, Attachment D summarizes the aggregate rate increases by plan that would be needed for 2004 and prior issues to get them to 2006 rate levels.

Attachment C indicates that there would have been a projected surplus as of 6/30/05 of approximately 12.28% of the present value of future premiums if 2006 rates had been effective beginning 7/1/05. Given these results and the objective to reduce rate subsidies between issue eras, I would like to propose that any future rate actions for in-force policies move rates towards 2006 rate levels. This will be discussed in more detail later in this document.

Rate Increase Scenarios

Attachment D summarizes the estimated one-time aggregate rate increases by plan needed to bring current rates to 2006 rate levels. Implementing these increases would lead to projection results consistent with those summarized in Attachment C.

Attachment E is an exhibit I have provided previously that has been revised to reflect the revised “base case” projection scenario discussed above, including a 10% explicit margin. This information could be utilized to understand the impact of “phasing in” the implementation of any needed corrective actions. As discussed previously, the longer we wait to implement the needed corrective action(s), the greater the needed adjustment and the greater the ultimate rate level(s).

Please note that I will bring a model to the Advisory Committee meeting that will allow us to review and discuss the impact of phasing in any needed rate adjustments.

Per the request of the Advisory Committee, I have developed Attachment F, which is an exhibit that indicates how the 2003 rate increase was “socialized”, and how that same socialization strategy would work given the current proposed corrective actions. Based on discussions I have been involved in recently, this type of socialization would likely not be pursued in the current scenario because of the Advisory Committee’s and Board’s desire to reduce rating subsidies.

Note: Attachment F should be considered a draft – our intent is to review and revise it in advance of the Advisory Committee meeting.

New Business Scenarios

Based on our calculations, on average, every \$1 of premium issued at 2006 rates should ultimately contribute a margin of \$2 to the program over the lifetime of that policy. As an example of the impact this could have, if the total amount of new business premium issued each year from 2007 through 2016 is approximately the same as the amount issued in 2005, the projected deficit as of 6/30/05 would be reduced by approximately \$80 Million or approximately 3.8% of the present value of future premiums. The following are a number of scenarios summarized for your review:

10 Years @ ½ Current Production Levels: \$40MM Deficit Reduction (1.9%)
15 Years @ ½ Current Production Levels: \$51MM Deficit Reduction (2.4%)
20 Years @ ½ Current Production Levels: \$59MM Deficit Reduction (2.8%)
10 Years @ Current Production Levels: \$80MM Deficit Reduction (3.8%)
15 Years @ Current Production Levels: \$102MM Deficit Reduction (4.8%)
20 Years @ Current Production Levels: \$117MM Deficit Reduction (5.6%)
10 Years @ 2x Current Production Levels: \$159MM Deficit Reduction (7.6%)
15 Years @ 2x Current Production Levels: \$204MM Deficit Reduction (9.6%)
20 Years @ 2x Current Production Levels: \$235MM Deficit Reduction (11.3%)

Please note that I will bring a model to the Advisory Committee meeting that will allow us to review and discuss the impact of any other new business scenarios.

Plan Migration Scenarios

While the migration of higher-benefit plans to lower-benefit plans would reduce the financial strain on the plan (i.e., by effectively making the current cash reserve amount worth more), it is very difficult to predict at this point how and to what extent this would occur as the program rates are currently structured. This item should be reconsidered after we have a better idea regarding what rate level adjustments might be made and the resulting impact on relative rate levels.

Improved Claims Management

As indicated in previous documentation, LTCG staff indicates that they expect this program to experience morbidity improvement of approximately 2%-3% in addition to improvement already accounted for in our projection results due to improved claims management practices and procedures.

Initial Proposed Mitigation Plan

Incorporating all of the data/information presented above, I would like to propose the following:

- That the minimum target funding level include a 10% margin at a 7.79% discount rate. Therefore, we should consider the projected funding deficit to be approximately 43%.

- That we implement a rate adjustment scenario that moves in-force rates to 2006 rate levels (as summarized in Attachment D).
- That we account for new business scenario described in the section above that would reduce the projected deficit by approximately 3.8%.
- That we not make any explicit provision for the impact of plan migration at this time.
- That we account for the 2%-3% additional future morbidity improvement identified by LTCG staff.

Given 2005 valuation assumptions, implementing this plan would essentially result in a projected surplus of between 15%-20% as of 6/30/05.

As noted previously, I will bring models to the Advisory Committee meeting that should allow us to run through various scenarios as they are discussed. Doing so should enable us to be as efficient as we can with the time we have together.

A Note Regarding Implementation

Based on my experience, regardless of the mitigation plan agreed upon, we will not be able to identify or understand all of the issues involved with the plan until we begin to work through the implementation process. Given that, I would recommend that any decisions made by the Advisory Committee or the Board be open-ended enough to allow for adjustments that are consistent with original intent. Of course, any adjustments would be subject to approval as well.

Benchmarking, Measurement and Reporting

Regardless of what plan is agreed upon and implemented, care should be taken that the appropriate benchmarks are set, measurements are in place, and reporting takes place so that those responsible for managing the program will have the data/information they need to understand how the program is progressing in relation to the plan established.

Ongoing Efforts

Given the subject matter(s) we are attempting to cover in this letter and in the upcoming Advisory Committee meeting, I have omitted the usual discussion of ongoing efforts. I will re-initiate this discussion in our next letter.

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Conclusion

Please feel free to contact me with questions/comments regarding anything presented to date at (317)575-7672 or via e-mail at kvolkmar@uhasinc.com.

Sincerely,

Karl G. Volkmar, FSA, MAAA, FCA
Consulting Actuary